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ABBREVIATIONS

GAO	General Accounting Office
FRS	Federal Reserve System
OMB	Office of Management and Budget

AUG 1 2 1980

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BY THE COMPTROLLER GENERAL

Report To The Congress

OF THE UNITED STATES

COMPLETED
ORIGINAL

Internal Auditing Can Be Strengthened In The Federal Reserve System

This report deals with the status of the Federal Reserve Systems' internal auditing activities and suggests ways to strengthen the use of internal auditing within the organization. On the basis of its study, GAO has concluded that the Federal Reserve System should:

--Establish a permanent, independent internal audit group at the Board of Governors.

--Require that Federal Reserve Bank internal audit groups review their Reserve Banks' banking supervision and regulation and economic research activities, particularly from the perspective of operational efficiency and effectiveness.

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AUGUST 8, 1980

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COMPTROLLER GENERAL OF THE UNITED STATES
WASHINGTON, D.C. 20548

B-197162

To the President of the Senate and the
Speaker of the House of Representatives

We made our review to determine if the Federal Reserve System is effectively using internal auditing as a tool to promote management efficiency and effectiveness. This report points out that the Federal Reserve Board of Governors has no permanent, independent internal audit group and that Federal Reserve Bank internal auditors are restricted from fully reviewing the efficiency and effectiveness of Reserve Bank supervision and regulation and economic research activities.

We are sending a copy of this report to the Chairman, Board of Governors of the Federal Reserve System.

Comptroller General
of the United States

COMPTROLLER GENERAL'S
REPORT TO THE CONGRESS

INTERNAL AUDITING CAN BE STRENGTHENED IN THE FEDERAL RESERVE SYSTEM

D I G E S T

Federal Reserve System top management should establish a permanent, independent internal audit group to serve the Board of Governors at headquarters and require that Federal Reserve Bank internal audit groups perform more operational reviews of their Reserve Banks' banking supervision and regulation and economic research activities.

THE BOARD OF GOVERNOR'S SHOULD ESTABLISH A PERMANENT, INDEPENDENT INTERNAL AUDIT GROUP

Although the Board of Governors has recognized the need for independent evaluations of its operations, it has not established a permanent, independent internal audit group. Components of the Office of the Controller, an external auditor hired by the Board, and the Board's Operations Review Program make periodic reviews of Board activities. However, none of these groups provide the fully independent, substantive evaluations of operations needed by the Board. (See p. 6.)

Each of the Board's current review efforts has limitations restricting either its independence or scope of activities. Components of the Office of the Controller make reviews designed primarily to carry out the Controller's responsibilities and enjoy no independent, direct reporting or operating relationship with the Board. (See p. 7.) Although the external auditor reports directly to the Board, its reviews are confined primarily to financial control areas. (See p. 10.)

Tear Sheet. Upon removal, the report cover date should be noted hereon.

The Operations Review Program, which makes reviews closely resembling those of an internal audit group, has encountered problems. The first arises because it is staffed entirely with part-time personnel detailed from other organizations who may be associated with the activities examined. To illustrate, in one of the two reviews completed to date, a review team leader reduced the scope of the review to avoid compromising his independence. Another problem is that followup on report recommendations has been inconsistent and incomplete because the Board has not made followup a part of normal Program responsibility.

While the Board has considered establishing a permanent, independent internal audit group, management has rejected the idea primarily because of a lack of funds and positions.

A new permanent internal audit function has been recently established in the Office of the Controller. In addition the Board staff is planning several actions to strengthen its Operations Review Program. However, the Office of the Controller's new internal audit unit lacks the necessary organizational independence and the Operations Review Program will continue to remain a part-time activity, even if the new plans are adopted. GAO believes that a permanent, independent audit group would be superior to these changes in meeting the established independent evaluation needs of the Board. (See p. 9.)

FEDERAL RESERVE SYSTEM MANAGEMENT SHOULD BROADEN THE ROLE OF FEDERAL RESERVE BANK GENERAL AUDITORS

The Reserve Bank General Auditors have concentrated nearly exclusively on financial and compliance audits and devoted little effort to operational audits of Reserve Banks' supervision and regulation and economic research activities.

The General Auditors at the 12 Federal Reserve Banks are all organizationally independent, aligned to report to the highest practicable level, and staffed with professionally qualified auditors. In addition, the General Auditors, acting collectively within their Conference of General Auditors, have established a System-wide set of auditing standards which are generally consistent with professional internal auditing standards. A quality control program has also been established within the System wherein each General Auditor unit is examined periodically by a review team. (See p. 19.)

In accordance with management's expectations, the General Auditors have conducted mainly financial, compliance, and procedural audits concentrating on matters of financial control. These audits have provided useful information to management. (See p. 19.)

However, by concentrating nearly exclusively on financial and compliance audits, little effort has been devoted to operational audits of Reserve Banks' banking supervision and regulation and economic research activities. Traditionally, General Auditors have:

--Not conducted audits of the efficiency and effectiveness of Reserve Bank supervision and regulation and economic research activities. (See p. 21.)

--Not effectively followed up on findings identified during Board of Governor's operational reviews of Reserve Banks' banking supervision and regulation and economic research activities. (See p. 31.)

Although the General Auditors, acting collectively within their Conference of General Auditors, have debated their audit role in the bank supervision and regulation and economic research areas several times, no collective approach toward auditing these areas has been formally adopted.

Uncertainty continues as to what the General Auditor's role should be regarding the evaluation of these activities. (See p. 29.)

Recently, the Staff Director for Federal Reserve Bank Activities, Federal Reserve Board, proposed that the General Auditors be excluded from reviewing areas involving bank examiners' judgments. This position is inconsistent with professional internal auditing standards which advocate an unrestricted scope of review. (See p. 30.)

RECOMMENDATIONS

GAO recommends the Chairman of the Board of Governors of the Federal Reserve System:

--Establish a permanent, independent internal audit group at the Board of Governors, consistent with professional internal auditing standards. (See p. 18.)

--Require that Reserve Bank General Auditors review the efficiency and effectiveness of bank supervision and regulation and economic research activities. (See p. 33.)

--Instruct the Conference of General Auditors to amend their "Audit Standards and Levels of Audit Attention for Federal Reserve Banks" to include (1) a System-wide approach toward reviewing bank supervision and regulation and economic research activities and (2) a specific operational policy statement requiring the General Auditors to follow up Board of Governor's reviews. (See p. 33.)

AGENCY COMMENTS

Although acknowledging that the Board of Governors' internal review program needs strengthening, and generally agreeing with GAO's comments regarding Federal Reserve Bank internal auditing activities, the Board did not agree with GAO's recommendations. Instead of establishing a permanent, independent internal audit group, the Board stated it would attempt to strengthen its existing Operational Review Program. The Board also continues to restrict the scope of Bank internal audit reviews to exclude any evaluation of professional efficiency and effectiveness as well as the end product of professional staff work. (See pp. 44-48.)

GAO continues to believe that the full adoption of its recommendations would strengthen the value of internal auditing activities to both Board and System management.

CHAPTER 1

INTRODUCTION

This report evaluates internal auditing within the Federal Reserve System (FRS). Internal auditing is an independent appraisal function established in an organization to examine and evaluate that organization's activities. Its overall objective is to assist management in discharging its responsibilities by furnishing information, analyses, appraisals, and recommendations pertinent to the organization's execution of management's policies and procedures. The internal auditing function uniquely supplements routine management checks through its independent approach and review methodology.

Every organization needs an effective system of internal management control. One of the best means of providing such control is by establishing effective internal auditing systems. The importance of internal auditing has been recognized by the Congress in a number of laws, particularly the Budget and Accounting Procedures Act of 1950. The act requires the head of each agency to establish and maintain accounting and internal control systems designed to effectively control and account for all funds, property, and other assets for which the agency is responsible.

The private sector, particularly the banking industry has also recognized the need for effective internal auditing systems. Many important firms have established internal audit units, which top management looks to for independent evaluations of operational efficiency and effectiveness.

STANDARDS USED TO EVALUATE INTERNAL AUDIT ORGANIZATIONS

We assessed FRS' internal auditing against widely accepted internal auditing standards which have been formulated for government and private industry, including banking. Within the government we have published policies and procedures for auditing programs and functions. The Office of Management and Budget (OMB) embodied these policies and procedures in its directives to executive agencies. For private industry, several organizations, including the Institute of Internal Auditors, Inc., and the Bank Administration Institute, have issued internal auditing standards.

While these standards may differ slightly in organization, they can be subdivided into three categories--general standards, examination or evaluation standards, and reporting standards. General standards applicable to an organization's internal audit activity include:

--Independence of auditors from activity audited.

--Professional proficiency of audit staff.

--Full review scope (financial operations, economy and efficiency, and program results).

--Due professional care.

Examination or evaluation standards include:

--Sound audit planning.

--Proper supervision of assistants.

--Adequate supporting evidence.

--Proper reviews of compliance with applicable laws and regulations.

--Complete evaluation of internal controls.

Reporting standards include:

--Timely reports to appropriate officials.

--Clear and accurate language.

--Adequate support of findings.

--Sound recommendations for improvement and consideration of issues requiring further study.

--Constructive tone, including mention of positive findings.

--Fair reporting of auditee's views.

--Adequate description of scope, including mention of information omitted for purposes of confidentiality.

FEDERAL RESERVE SYSTEM HAS MANY FUNCTIONS

The Federal Reserve System was created on December 23, 1913, by the Federal Reserve Act (38 Stat. 251; 12 U.S.C. 221). Specifically the act established Federal Reserve Banks, supervised by a Board of Governors to carry out monetary policy and to improve the supervision of banking in the United States, as well as provide various central banking services for member banks and the U.S. Government. FRS has been entrusted with many supervisory and regulatory functions:

--Approving or denying applications for various actions, such as for branches, mergers, bank holding company formation, capital stock or debenture issues, and membership in FRS.

--Determining margin requirements; i.e., the amount of credit that may be extended to purchase or hold equity securities.

--Regulating the foreign activities of all member banks.

--Regulating the activity of bank holding companies.

--Administering securities registration requirements (under the Securities Exchange Act of 1934) that apply to State member banks.

--Establishing rules for all lenders of consumer credit to disclose interest on loans and terms of repayment ("truth in lending").

--Examining State member banks, bank holding companies and their nonbank subsidiaries, and Edge Act and agreement corporations.

In addition to these functions, the FRS also provides banking type services for both the U.S. Government and FRS member banks. FRS services the Government's checking account--Reserve Banks pay all checks drawn on the Treasury. In addition, FRS participates in the sale, transfer, and

redemption of Government securities. For its 5,500 member banks, FRS operates a nationwide clearinghouse service for checks and other noncash items, participates in the circulation of currency, and provides nationwide wire transfer services.

The level of these banking activities is enormous. In 1978, FRS

--processed 14.8 billion checks totaling $7.6 trillion, including over 700 million Government checks amounting to approximately $439 billion;

--assisted in the sale, transfer, or redemption of over 280 million Government securities totaling over $8 trillion; and

--processed 29 million transfers of funds totaling in excess of $50 trillion.

To carry out these responsibilities, FRS has a 7-member Board of Governors, supported by 13 major headquarters divisions and offices in Washington, D.C., and a system of 12 Federal Reserve Banks with 25 branches throughout the country. In addition, in 1979, FRS had an operating expense budget of $803.8 million ($754.0 million for the Reserve Banks and $49.8 million for the Board), which included salaries for 24,661 authorized staff positions (23,151 at the Reserve Banks and 1,510 at the Board). FRS also had a 1979 capital expenditure budget of $73.6 million.

FRS is financed mainly by interest on its holdings of U.S. Government securities, which it acquires in the process of creating bank reserves. After FRS operations have been financed, interest income left over is returned to the Treasury.

FRS's management control strategy is described in Appendix I. This strategy consists of a functionally aligned organizational structure, supplemented by various formal information systems. Internal auditing is a part of this control strategy.

HISTORY OF THE FEDERAL RESERVE SYSTEM INTERNAL AUDIT FUNCTION

Since its organization in 1914, FRS has recognized the need for and has used internal auditing. Most of the Federal Reserve Banks have used internal auditing to

conduct independent audits of their activities. And, as part of its supervisory function over the Reserve Banks, the Board of Governors has been conducting examinations of Reserve Bank activities since FRS' organization. Although the Board has not established an independent internal audit group, its accounts have always been audited by outside sources.

Nine of the 12 Reserve Banks had established internal audit groups by 1916 to perform such duties as semimonthly audits of the tellers' cash, monthly audits of the vault cash and the loan department, and continuous audits of the Federal Reserve notes and gold. Today, the Reserve Bank General Auditors conduct audits of over 45 Reserve Bank activities.

The Board has also conducted examinations of the Reserve Banks since 1914. The Division of Audits and Examination (a predecessor to the Division of Federal Reserve Bank Operations) conducted the early Reserve Bank examinations on a semiannual basis. The Division's overall objectives were to determine how economically the Reserve Banks administered their activities and how they maintained their internal control, including the auditing system. The resulting report was to be filed with the Reserve Banks and examined and initialed by each member of the board of directors. Presently, five Board divisions, including the Division of Federal Reserve Bank Operations, conduct reviews of Reserve Bank activities.

Since its origin, the Board of Governors' internal control system has not included an independent internal audit group. The Board's accounts, however, have been audited by outside sources since 1917. During the period 1917 through 1933, the Board's accounts passed through the Office of the Auditor for the State Department and other Departments and were officially examined as required by the Government. From 1934 through 1951, the Board arranged for Reserve Bank auditors to audit and certify Board accounts. In 1952, the Board began contracting with public accounting firms to audit and certify its accounts. Using a competitive bid process, the Board entered into a new contract with a public accounting firm in 1979 to continue these services.

CHAPTER 2

THE BOARD OF GOVERNORS SHOULD ESTABLISH A PERMANENT, INDEPENDENT INTERNAL AUDIT GROUP

Although the Board of Governors has recognized the need for independent evaluations of its operations, it has not established a permanent, independent internal auditing group. Components of the Office of the Controller, an external auditor hired by the Board, and the Board's Operations Review Program periodically review Board activities. However, none of these groups provide the fully independent, substantive evaluations needed by the Board.

Each of the Board's current review efforts restricts either its independence or scope of activities. Although components of the Office of the Controller make reviews designed primarily to carry out the Controller's responsibilities, they enjoy no independent, direct reporting or operating relationship with the Board. Although the external auditor reports directly to the Board, its reviews are confined primarily to financial control areas.

The Operations Review Program, which makes reviews closely resembling those of an internal audit group, has encountered problems. The first arises because it is staffed entirely with part-time personnel detailed from other organizations who may be associated with the activities examined. To illustrate, in one of the two reviews completed to date, a review team leader reduced the scope of the review to avoid compromising his independence. Another problem is that followup on report recommendations has been inconsistent and incomplete because the Board has not made followup a part of normal Program responsibility. While the Board has considered establishing a permanent internal audit group, management has rejected the idea primarily because of a lack of funds and positions.

A new permanent internal audit function has been recently established in the Office of the Controller. In addition, the Board is planning actions to strengthen its Operations Review Program. However, the Office of the Controller's new internal audit unit lacks necessary organizational independence and the Program will continue to remain a part-time activity, even if the new plans are adopted. We believe a permanent, independent audit group would be superior to these changes in meeting the established independent evaluation needs of the Board.

CONTROLLER'S SECTION INTERNAL REVIEW ACTIVITIES DO NOT PROVIDE SYSTEMATIC INDEPENDENT FEEDBACK DIRECTLY TO THE BOARD OF GOVERNORS

The Office of the Controller's Finance and Accounting, Program and Budgets, and System Improvement Sections provide the Controller, and to some extent, the Board's Staff Director for Management, with limited internal review capabilities in the financial, budgeting, and operational control areas. Selected staff within these components are occasionally called upon to participate in ad hoc studies, with the results reported to the Board. However, the results of regular section reviews are not reported directly to the Board of Governors.

In January 1980, the Board established two permanent internal audit positions within the System Improvement Section. However, the organizational placement of these activities, reporting to the Assistant Controller, is inconsistent with professional internal auditing organizational independence standards and the organizational placement of all the Reserve Bank internal auditors throughout FRS.

Finance and Accounting Section reviews are part of the Office of the Controller's internal control system

In addition to its operational duties, such as processing the payroll, maintaining the Board of Governor's financial records, and determining bank assessments, the Finance and Accounting Section conducts limited reviews of selected financial controls. These reviews deal with cash, travel requests, and petty cash. The section also observes the physical inventories of equipment, supplies, and furniture. Normally, these reviews do not result in formal reports and the results are stored within the section. On rare occasions, section personnel have participated in special reviews which have led to reports to the Board. These efforts have been triggered by the section's detection of irregularities which appear related to fraud. When the Controller determines a special review is needed, the results are reported through him to the Board.

This section does not possess many of the characteristics required of an independent audit unit serving the Board. For example, instead of the Board:

--The Controller receives reports of all efforts and decides if the Board needs to be informed.

--The Controller decides the amount of resources to be devoted to these reviews and determines the review coverage.

The section chief strongly denied that these activities were independent internal audits, stressing that these reviews should not be assessed against professional internal auditing standards.

Program and Budgets Section reviews serve the Controller

As part of its budget responsibilities, the Program and Budgets Section conducts budget-related reviews. These reviews are normally evaluations of budget requests, such as requests for additional positions, made by other Board organizations. Between January 1978 and April 1979, this section conducted seven of these studies, all of which resulted in reports distributed within the Office of the Controller. These reviews are normally initiated by the section manager and are primarily aimed at facilitating the Controller's role in the Board budgeting process. (See app. I for a description of the Board's budgeting process.) While noting that these reviews provide useful information for the Board's budgetary process, Office of the Controller officials acknowledged that these reviews should not be considered independent internal audits.

System Improvement Section reviews are limited, internal management consultant oriented efforts

The System Improvement Section's responsibilities include identifying system improvement areas, studying and appraising existing systems, and evaluating new systems' performance. Operating primarily with one full-time staff person, assisted by another staff person on a part-time basis, the section conducted or participated in three projects during the period from January 1978 to April 1979. Past projects have included conducting studies of payroll processing procedures and leave administration, assisting in the implementation of external auditors' recommendations,

and recommending methods to decrease production and distribution costs of regulatory materials. Projects normally result from requests made by either the Staff Director for Management or the Controller.

This section has no direct reporting or operating relationship with the Board of Governors; the Controller decides the level of resources devoted to its reviews. It normally reports its evaluation results to the entity reviewed and to either the Controller or the Staff Director for Management. The section also has no formal authority to unilaterally initiate reviews, relying instead on invitations or requests from line management officials, the Controller, or the Staff Director for Management. In addition, if recommendations are made, the section plays no role in monitoring management's subsequent actions to see if these recommendations were addressed.

Controller's new internal audit activities are not organizationally independent

At the completion of our fieldwork, the Controller indicated that he recently established a permanent internal audit function, consisting of two permanent positions, within the Systems Improvement Section. These internal auditors would report through the section chief to an Assistant Controller.

This organizational placement of internal auditing is inconsistent with professional internal auditing independence standards and the practices followed throughout the rest of FRS. Professional standards note the need to avoid placing the internal auditors in an organizational position where their independence may be impaired through being subjected to the administrative or policy guidance of potential line management auditees. The 12 Federal Reserve Banks have recognized the need for internal audit independence by organizationally placing their auditors outside line management control and by having them report to audit committees composed of selected Reserve Bank board of directors.

In the Controller's planned organizational placement, these internal auditors will receive administrative and policy guidance from an Assistant Controller, who, in turn, will receive such guidance from the Controller. Although he reports directly to the Board on selected matters, the Controller, in turn, is administratively accountable to the Board's Staff Director for Management, whose broad administrative control covers a wide range of Board operations.

As a result, these internal auditors are not organizationally independent from many of the managers whose activities they may be called upon to audit.

EXTERNAL AUDITOR PROVIDES AN INDEPENDENT AUDIT OF THE BOARD'S FINANCIAL ACTIVITY

Although the external auditor enjoys a direct reporting relationship to the Board of Governors, these audits are limited, in large part, to financial control activities. Many areas of important Board operational activities remain outside the scope of these audits.

As a part of its management control approach, the Board of Governors employs an external auditor to annually examine the Board's financial statements and review the procedures used in the Reserve Bank examination process by the Division of Federal Reserve Bank Operations. This review includes an examination of the existing internal accounting controls and the rendering of an opinion on the fairness of statement presentations. Currently, these two reviews are performed by the same external auditor under separate contracts.

Although these reviews are useful, operational efficiency and effectiveness issues are not their focus. Only 1 of the Board's 12 primary Divisions and Offices, the Division of Federal Reserve Bank Operations, is reviewed from an operational perspective. Further, the scope of this review is limited to selected activities.

THE OPERATIONS REVIEW PROGRAM HAS ENCOUNTERED PROBLEMS

The Operations Review Program, which makes reviews closely resembling those of an internal audit group, has encountered problems. The first arises because it is staffed entirely with part-time personnel detailed from other organizations who may be associated with the activities examined. To illustrate, in one of the two reviews completed to date, a review team leader reduced the scope of the review to avoid compromising his independence. Another problem is that followup on report recommendations has been inconsistent and incomplete because the Board has not made followup a part of normal Program responsibility.

In 1978, the Board established the Operations Review Program, giving it the broadest mandate of the Board's review efforts. The Program administered by the Operations Review Committee has the following objectives:

--Reviewing internal administrative and financial controls.

--Ensuring compliance with applicable laws, regulations, and policies.

--Assessing the effectiveness and economy of resource management.

--Determining whether internal operating objectives are established and achieved in an effective manner.

The results of these reviews are to be reported to the Vice Chairman of the Board, members (Governors) of the Board committee responsible for oversight of the division or office reviewed, the head of the Division or Office reviewed, and either the Board's Staff Director for Management or the Staff Director for Federal Reserve Bank Activities.

To accomplish these objectives, Board staff indicated that several approaches were considered, including the establishment of a permanent internal audit group. The need for a permanent internal audit group had been raised before. A special 1975 study of the Board's procurement function, conducted by staff from the Office of the Controller, recommended that FRS establish a separate internal audit group for the Board. Their report recommended, in part, that FRS establish this function to provide the Board with an "objective evaluation of the effectiveness and efficiency with which internal control and related financial activities are being performed." The staff felt that such a review program would be a "useful management tool" and a "continuing supplement to the external audit." No action was taken on the report recommendations.

In 1978, Board staff reconsidered the auditing needs of the Board of Governors. They rejected the alternative of a permanent internal audit group for several reasons. First, they believed that, because most Board operations had never been audited, Board management needed to be educated as to the benefits of having operational audits performed. As a result, they thought that an organization

requiring extensive line management involvement would be better suited to the Board's educational needs, than a separate, permanent group which might not be fully accepted by management.

In addition, because of budgetary constraints limiting the number of available permanent positions and the availability of Board and Reserve Bank personnel with operational review experience, the Board's staff felt that a nonpermanent structure was both desirable and feasible.

Subsequently, in response to the need for a nonpermanent structure, the Board organized the Operations Review Committee. This Committee, which reports to the Vice Chairman of the Board of Governors, is composed of seven key senior Board managers who serve on a part-time rotational basis in addition to performing their other regular duties. The Program's review staff, including the team leader, can be selected on a temporary basis from the Board, Reserve Banks, or external consulting organizations, such as CPA firms. Although the formulation of a full-time, internal audit group was rejected, the Committee's policy statement indicates the Program's review standards will be "consistent" with review standards developed by us, the American Institute of Certified Public Accountants, and the Institute of Internal Auditors, Inc. While the two operational reviews performed to date have produced useful recommendations, problems have developed.

Scope of review reduced to avoid a compromise of independence

The use of part-time personnel to perform Program reviews has led to the scope of one review being reduced to avoid a compromise of the review team leader's independence. In addition, through the continued use of Reserve Bank personnel as review team members in its reviews, the Program may compromise the independence of its future reviews of several important Board activities.

The Program's standards call for both Committee members and review team members to be independent "in all matters relating to the operational review process." "The following situations provide examples of how this standard will be applied:

--"Committee Members will refrain from participating in any review related deliberations involving divisions or offices in which they have had previous decision making or other management responsibilities if such relationships compromise their independence.

--"The Committee will assess all review staff assignments to ensure that no individuals are assigned to review activities who would be subject to employment related pressures that may affect their ability to form independent and objective opinions and conclusions."

Despite these standards, the Committee assigned a review team leader to its review of the Division of Banking Supervision and Regulation even though he had previous program responsibilities which could compromise his independence. The Program's review of this Division included evaluating the Division's periodic reviews of the 12 Reserve Banks to ensure that Board policies were being implemented correctly. At the time of the Program's study, the Division's review responsibilities were new, having recently been transferred from the Board's Division of Bank Operations. The Program's team leader was previously a member of the Division of Bank Operations and conducted reviews of Reserve Banks to ensure that the Board's banking supervision and regulation policies were being implemented. He helped create the review program used in this area by the Division of Bank Operations and subsequently by the Division of Banking Supervision and Regulation. As a result, the team leader had strong personal convictions regarding this particular activity.

Because the Division of Banking Supervision and Regulation's review teams were essentially using his review program to conduct their reviews, the Program's team leader limited the scope of his review of this new but growing activity area. Although one recommendation regarding this area appeared in the report, none of the Program's review steps directly addressed this activity and no evidence was gathered evaluating this area. The Committee's Coordinator for Review Activities indicated that the team leader was chosen because of his expertise in the area and that the Committee was unaware of any review scope restrictions.

The potential for compromising Program review independence also exists when Reserve Bank personnel are used

to review areas with which they have ongoing official relationships. All five team members from the Reserve Banks had ongoing official relationships with the Division of Banking Supervision and Regulation as part of their regular Reserve Bank responsibilities. Several Reserve Bank officials recognized this potential before the Program's review of the Division of Banking Supervision and Regulation. While noting his concern may not be "well founded," one Vice President noted:

> "The objectivity with which an individual from a Reserve Bank approaches this assignment could be influenced by the knowledge that individuals from these same divisions at the Board participate in reviewing his operations at the Reserve Bank. This, in turn, could influence the evaluation of the individual himself, as well as influencing the overall evaluation of the bank."

A second Reserve Bank Vice President refused to offer any review team candidates for one of the reviews, noting:

> "To select someone from our supervision staff to review and evaluate the division which supervises and reviews his own work or the work of his department is a reversal of the evaluation process which could cause problems. The reviewer could be excessively critical, if he happens to be smarting from having been on the receiving end of a recent unfavorable critique, or, more likely, he could be excessively careful not to criticize, knowing that in the future the shoe will be on the other foot."

The potential for compromising independence is present in future Program efforts. Five of the 12 primary Divisions and offices, which are within the Program's scope of review, are or will be, involved in reviewing Reserve Bank operations in their areas. Since in the first two reviews, Reserve Bank personnel made up a large part of the staff, extensive Reserve Bank personnel participation in future reviews appears likely.

<u>The Program plays a minimal role in report recommendation followup</u>

The Program's policies note that its responsibilities end upon distribution of the final report. Followup on proposed corrective actions is the responsibility of the

Board of Governors, the Offices of the Staff Directors, and division and office management. The Program will be involved only if requested by management. Inconsistent and incomplete followup on report recommendations has resulted.

Professional internal auditing standards note the need for internal audit groups to periodically follow up on their reported audit findings to determine that corrective action was taken and is achieving the desired results, or that management has assumed the risk of not taking corrective action on reported findings. OMB Circular A-73 has also noted the importance of report recommendation followup by requiring executive agencies to establish audit report recommendation followup policies, including designating officials responsible for followup, maintaining a record of the action taken on recommendations, establishing time schedules for responding to and acting upon recommendations, and submitting periodic reports to agency management on action taken.

The current policy of relying on management to follow up on the Program's report recommendations has not produced consistently effective followup actions. No one independent of management is determining that planned actions take place, and one auditee acknowledged that followup on actions taken did not exist because the Board did not require it. Management's initial responses to the Program's May 1979 report were often vague about what actions would be taken or when they would occur. In December 1979, management said that many of these recommendations were under "continuing" consideration, but no record was maintained of the actions taken, no time schedules were established for responses or actions, and no periodic reports were made to top management on actions taken.

Management initially responded to the Program's August 1979 report with a plan outlining the actions to be taken and target dates; however, 25 actions contained no target dates for completion. In contrast with the other auditee, however, this Division maintained records of actions taken in response to the recommendations, although periodic reports to top management had not been initiated as of the completion of our work. In one of the two instances, management also noted that no actions would be taken on those recommendations which it felt were outside its unilateral control.

Actions to be considered by the Operations Review Committee

At the completion of our fieldwork, the Committee's Coordinator for Review Activities indicated that the Committee will be reassessing the operations of the Program in the near future. He plans to recommend changes in the reporting process and format. While these changes represent improvements to current operations, we believe that many of the problems encountered by the Program are inherent in its nonpermanent nature.

CONCLUSION

Although the Board has recognized the need for independent evaluations of its operations, it has not established a permanent, independent, internal audit unit. Components of the Office of the Controller, an external auditor hired by the Board, and the Operations Review Program made periodic reviews of the Board's activities. However, none of these groups provide the fully independent, substantive evaluations needed by the Board.

Each of the Board's current review efforts has limitations restricting either its independence or scope of activities. Components of the Office of the Controller make reviews designed primarily to carry out the Controller's responsibilities and therefore enjoy no independent, direct reporting or operating relationship with the Board. These reviewers receive administrative and policy direction from the Controller, who in turn, receives administrative and policy direction from the Board's Staff Director for Management. Although the external auditor reports directly to the Board, its reviews are confined to the financial control areas.

The Operations Review Program, which makes reviews closely resembling those of an internal audit group, has encountered problems. The first arises because it is staffed entirely with part-time personnel detailed from other organizations who may be associated with the activities examined. To illustrate, in one of the two reviews completed to date, a review team leader reduced the scope of the review to avoid compromising his independence. Another problem is that followup on report recommendations has been inconsistent and incomplete because the Board has not made followup a part of normal Program responsibility.

While the Board has considered establishing a permanent internal audit group, management rejected the idea primarily because of a lack of funds and positions. Although a permanent internal audit function has been established in the Office of the Controller and the Board is planning several actions to strengthen the existing review organizations, we believe a permanent, independent audit group would be superior to the existing structure in meeting the established independent evaluation needs of the Board.

To ensure independence, the internal audit group should report to the highest practicable level. One approach would be to report to the Vice Chairman. Another approach would be to draw upon the experience of Federal Reserve Banks and establish an audit review committee consisting of members of the Board of Governors. As discussed in the following chapter, FRS management has supported internal audit organizational independence by encouraging, at each of the individual Reserve Banks, the maintenance of Audit Review Committees consisting of members of the Reserve Banks' board of directors.

AGENCY COMMENTS AND OUR EVALUATION

While acknowledging that its Operational Review Program needs strengthening, the Federal Reserve Board of Governors did not agree to establish a permanent, independent internal audit unit. The Board expressed its satisfaction that the current combination of the Office of the Controller, the external auditor, and the new Operational Review Program will satisfy its needs and requirements. The Board believes that the current structure of the Office of the Controller is appropriate, including the placement of an internal audit function within the Office's Systems Improvement Section. In addition, the Board instructed the Vice Chairman to effect improvements in the Operational Review Program's charter in the areas of independence conflicts and followup responsibilities, including hiring a full-time director. The Board's response does not identify the specific improvements under consideration. A member of the Board staff told us that the specific improvements have not been developed as yet. (See Appendix II.)

We continue to believe that a permanent, independent internal audit group should be established by the Board of Governors. The Board's assertion that its placing of internal auditing activities under the Controller, a major auditee, is appropriate, ignores professional internal auditing standards which stress the need for internal auditing activities

to maintain their organizational independence from auditees. This organizational placement is also inconsistent with the internal audit organization practices observed by the rest of the Federal Reserve System.

Although the hiring of a full-time director for the Operational Review Program represents a positive step, other problems identified in our report remain to be addressed. The Program's review staff will continue to be drawn from other System sources on a part-time basis, thereby perpetuating the need for thorough Program scrutiny of each review team member to insure that reviewer independence is not impaired. This screening process has not been fully successful to date. In addition, with the establishment of a permanent Program director, two permanent internal review programs now exist, with potentially duplicative program objectives.

RECOMMENDATION

We recommend the Board of Governors establish a permanent, independent internal audit group, consistent with professional internal auditing standards. This unit should be organizationally independent of line management functions and report to the highest practicable level in the organization, either to the Vice Chairman of the Board of Governors or to an audit committee of the Board of Governors chaired by the Vice Chairman.

CHAPTER 3

FEDERAL RESERVE SYSTEM MANAGEMENT SHOULD BROADEN THE ROLE OF FEDERAL RESERVE BANK GENERAL AUDITORS

Although Reserve Bank General Auditors have resource support, organizational independence, professional standards, and a quality control program; they have concentrated nearly exclusively on financial and compliance audits. Traditionally, General Auditors have devoted little effort to

--conducting audits of the efficiency and effectiveness of Reserve Bank supervision and regulation and economic research activities and

--effectively following up on findings identified during Board of Governor's operational reviews of Reserve Bank supervision and regulation and economic research activities.

Uncertainty continues as to what the General Auditors' role should be regarding the evaluation of these activities. Recently, the Staff Director for Federal Reserve Bank Activities proposed that the General Auditors be excluded from reviewing areas involving bank examiners' judgments. This position is inconsistent with professional internal auditing standards which advocate an unrestricted scope of review.

MANAGEMENT HAS MAINTAINED PROGRESS TOWARD ESTABLISHING A PROFESSIONAL INTERNAL AUDIT FUNCTION AT EACH RESERVE BANK

FRS management has generally encouraged the development of a professional internal audit function at each Reserve Bank. A System-wide set of standards has been developed, staffing resources have been provided, organizational independence has been achieved, and a quality control system has been established wherein each Reserve Bank internal audit unit is periodically reviewed by a Board of Governor's review team. Historically, the General Auditors have concentrated their efforts in financial and compliance audits in areas of high financial exposure.

FRS management has provided Reserve Bank internal audit units with resource support, organizational independence, professional auditing standards and a quality control system

To be fully effective, an internal audit unit needs adequate staff resources, organizational independence, established performance standards and an effective audit quality control system. Our review of Reserve Bank internal audit operations showed that FRS management has:

--Provided adequate funds, with a 1979 combined operating budget of $14 million for the 12 General Auditors, ranging from $2.5 million for New York to $0.5 million for Minneapolis.

--Assembled qualified audit staffs, with over 67 percent of the System's professional auditing staff members having college degrees, ranging from 95 percent in Philadelphia to 38 percent in San Francisco.

--Supported internal audit organizational independence by encouraging, at each of the individual Reserve Banks, the maintenance of Audit Review Committees consisting of members of the Reserve Banks' board of directors.

--Established in 1936 and updated in 1974 and 1977 a set of System-wide auditing standards and audit frequency guidelines, providing the system with a set of audit approaches and performance standards which include (1) financial audits--verification through count, confirmation, or examination to the degree necessary to establish the accuracy of recorded balances or accountabilities, (2) procedural audits--evaluation, through observations, test and inquiry, of the adequacy and effectiveness of internal control with careful attention to compliance with established policies, procedures, and regulations, (3) transactional audits--review of the underlying documentation supporting recorded transactions for a specified period of time to determine the propriety of supporting documentation, the completeness of recorded transactions, and the adequacy of documents serving as managerial control reports, (4) operational audits--appraisal of the overall efficiency and effectiveness of operations by evaluating the control techniques

used in promoting operational efficiency and effectiveness. Operational auditing is an optional extension of the traditional audit activity designed as a positive service to management.

--Maintained an active quality control system, featuring periodic reviews of the operations of each of the 12 Reserve Bank internal audit units by the Audit Review Section of the Board's Division of Bank Operations.

General Auditors have emphasized financial, transactional and procedural audits of financial activities

Board officials have emphasized that Bank internal audit efforts have been primarily concerned with testing controls in areas of high financial exposure. A breakdown of the 6,968 audits, identified by the General Auditors as having been performed during the period from January 1978 to April 1979, shows that 6,024 were either financial, transactional, or procedural audits; only 163 were operational audits. The remaining 781 audits were combined audits with 297 containing some operational audit aspects.

These audits were heavily concentrated in testing financial controls and procedures, particularly in the valuables handling area. Our review of the 1979 audit plans for the 12 Banks indicates that 88 percent were to be concentrated on reviewing financial controls and procedures.

FEDERAL RESERVE BANK AUDITS OF BANK SUPERVISION AND REGULATION AND ECONOMIC RESEARCH SHOULD BE INCREASED

The General Auditors have concentrated their audit activity in areas of high financial exposure and have rarely reviewed either the efficiency or the effectiveness of their Reserve Bank's supervision and regulation and economic research activities. In addition, General Auditors have not established policies to effectively follow up on findings identified during Board reviews of these activities in their Banks. Although these activity areas do not involve high financial exposure, both are important program areas in which problems have been identified by both the Board reviews and the one review to date performed by a Reserve Bank General Auditor.

The Conference of General Auditors has debated the audit role of the General Auditor in these areas several times. However, no collective approach toward these areas has been formally adopted. Recently, the Staff Director for Federal Reserve Bank Activities proposed that General Auditors be restricted from reviewing areas involving bank examiners' judgments. This proposal is inconsistent with professional internal audit standards which advocate an unrestricted scope of review for internal auditors.

To be of maximum usefulness, the scope of the internal auditor's activity should extend to all agency activities and related management controls. The full scope of an audit of a governmental program, function, activity, or organization should encompass

--an examination of financial transactions, accounts, and reports, including an evaluation of compliance with applicable laws and regulations,

--a review of efficiency and economy in the use of resources, and

--a review to determine whether desired results are effectively achieved.

In addition, with regard to both internal and external audit report recommendations, followup should be made to see that action was taken and is achieving the desired results, or that management has assumed the risk of not taking corrective action on reported findings.

Bank supervision and regulation and economic research are important system policy activities

At the Board of Governors, Board division and Reserve Bank levels, the bank supervision and regulation and economic research areas are high priority functions. Although the amount of funds expended on the two functions is relatively small, these areas are important from a program perspective.

A paragraph added to section 9 of the Federal Reserve Act in 1917 specifically directs FRS to perform supervisory functions over its member banks. In reference to member banks, it states:

> "As a condition of membership such banks shall likewise be subject to examinations made by direction of the Board of Governors of the Federal Reserve System or of the Federal Reserve Bank by examiners selected or approved by the Board of Governors of the Federal Reserve."

Activities under the auspice of the FRS bank supervision and regulation function include bank mergers, applications for new banks, and financial institution supervision.

The overall objectives of the research and statistical function are collecting, preparing, and developing economic and financial information for use by Board, Federal Open Market Committee, and other System officials. Such information is to be used by FRS to formulate credit and monetary policies, to execute supervisory and regulatory responsibilities over financial institutions, to maintain the operational status of the Federal Reserve System, and to produce financial and economic statistics for publication.

The role of the Board in bank supervision and regulation and economic research is one of policy and decision-making and approval of certain applications related to activities of financial institutions. The Board established the policies and regulations to direct the System's administration of the functions, which include monitoring financial institution operations and collecting and processing economic data. In addition, processing certain applications for bank holding companies, acquiring shares in other banks, and establishing new banks require Board approval. A review of the Board's meeting minutes, from August 1978 to August 1979, indicates that, of the 562 issues considered, 348 were directly related to these activities. Recognizing the importance of these activities, two of the four standing committees of the Board specifically address these areas.

These activities have also been recognized as important at the Division level within FRS. The Division of Bank Supervision and Regulation serves as the overall coordinator of FRS activities in the bank supervision area. Generally, the Division is charged with initiating new procedures and developing and implementing Board directives pertaining to general bank examination policies and procedures.

The Division's responsibilities include (1) keeping the Board informed of current and prospective developments in bank supervision and banking structure, (2) coordinating the System's bank supervision and examining activities, and (3) processing and presenting to the Board various types of applications for prior consent to form or expand bank holding companies or make other changes in banking structure. Although the Board has delegated some application approval authority to the Reserve Banks, the Division still has overall responsibility for coordinating application processing in the System. Division involvement also includes special bank and bank holding company examinations and participation in the training of Reserve Bank examiners.

Similarly, the Research and Statistics Division serves as the focal point for preparing statistical data for FRS use. Generally, the Division develops economic and financial information, which covers such areas as Government mortgage and consumer finance, capital markets, and general business conditions. After analyzing the data, the Division presents the analyses to the Board, the Federal Open Market Committee, and the general public.

Although the Board of Governors issues the policies adhered to by the Reserve Banks in administering their bank supervision and regulation and research functions, the Reserve Banks have very distinct and important implementation responsibilities. All 12 Reserve Banks have established specific bank supervision and regulation and economic research departments within their organizational structures. The Reserve Banks, under delegated authority from the Board, are responsible for the administration of bank supervision, including the examination of State member banks and bank holding companies.

In 1979, the Reserve Banks conducted 988 examinations of member banks and 581 examinations of bank holding companies. In September 1979, their application approval authority was increased by the Board, providing them with authority to approve certain bank holding company or merger applications and to prepare all competitive factor reports on mergers decided by the Comptroller of the Currency and the Federal Deposit Insurance Corporation. Each Reserve Bank's economic research function collects, processes, and transmits approximately 80 statistical reports to the Board as its primary activity. Generally, Reserve Bank departments of research, bank supervision and regulation, and accounting are responsible for producing these reports.

Limited reviews of bank supervision and regulation and economic research activities have identified problems

Reviews of bank supervision and regulation and economic research activities conducted by Board of Governors review teams have identified a variety of problems associated with the implementation of these functions. In addition, the one economy and efficiency review of bank regulation and supervision activities performed by a Reserve Bank General Auditor, also identified a variety of problem areas.

In the bank supervision and regulation area, Board review teams have identified a variety of problems. The overall objective of these limited reviews is to determine if Reserve Banks are providing an adequate framework, through their practices and policies, to effectively regulate and supervise their member institutions.

Using a questionnaire approach, Board review teams consisting of three to five members, perform 1 to 2 week onsite reviews of Reserve Banks under the direction of the Division of Bank Supervision and Regulation. These reviews are generally performed once every 3 years and Board followup does not normally occur until the next review.

The seven reports completed by Board review teams during the period from June 1977 to March 1979 contained 138 separate recommendations. Most of these recommendations were directed toward commercial examinations, bank holding company inspections, and general administrative duties. For example:

--Forward all significant correspondence received from member banks to the Board to fully inform it of concerns on a current basis.

--Request specific action plans from bank holding companies on how problems will be addressed if findings reveal capital deficiencies.

--Discontinue the practice of listing details in examination reports which include information on each public fund deposit.

--Institute a formal restructuring of divisional responsibilities.

--Establish internal time limits for every major phase of the report processing cycle.

As in the bank supervision and regulation area, Board review teams perform limited reviews of the Reserve Bank activities in the research and statistical area and have determined that problems exist in the Reserve Bank's administration of the function. The objective of the review is to determine the effectiveness and efficiency of operating procedures, including identifications of operational problems and issues with possible System-wide impact. A team, usually consisting of four members, performs a 1-week onsite review of the function at Reserve Banks. The teams generally perform these reviews once every 4 years and followups to prior reviews usually occur at this time. From December 1978 to June 1979, Board teams reviewed the function at four Reserve Banks, making a total of 192 recommendations. Specific examples of these recommendations include:

--Instituting an additional control mechanism to monitor the flow of reports to data processing.

--Establishing adequate backup systems for processing data.

--Establishing internal guidelines to serve as guideposts for an orderly progression to the Board's deadlines.

In addition to the problems identified in Board reviews the one economy and efficiency review of bank supervision and regulation and economic research activities performed by a Reserve Bank General Auditor during the period from January 1978 to April 1979, also identified performance problems. The San Francisco General Auditor reviewed his Reserve Bank's supervision and regulation activities in 1978 to determine whether (1) the section's policies and procedures provided a framework for effective supervision of State member banks, (2) the section followed Reserve Bank and FRS required procedures, (3) the section was operating in a cost-effective manner, and (4) the section's supervision and administration were effective and efficient. The scope included a review of examination planning, workpapers generated during the examination, completed reports, and onsite observations of opening and closing discussions of an examination. The General Auditor's findings on commercial examination by the Reserve Bank included:

--Time was insufficiently allocated for an indepth examination of the member bank audit department.

--Documentation citing the reason the Reserve Bank did not address certain areas in its examination was lacking.

--Evidence was unclear and documentation of supervisory review of evidence was lacking.

--Fieldwork that was incomplete at the close of the examination was not clearly indicated, and follow-up procedures were not formalized.

--A standardized format, to inform the examiner-in-charge of violations, exceptions, and recommendations, was not used.

--Meetings with the bank directors were not always held at the close of an examination.

As indicated above, both of these activities, when reviewed, have been found to contain reportable items needing management attention.

General Auditors have not effectively addressed the efficiency and effectiveness of bank supervision and regulation and economic research functions

Although operational problems have been identified in bank supervision and regulation and economic research functions, General Auditors have not, except in the instance discussed above, reviewed either the efficiency or effectiveness of these functions in their Reserve Banks. In addition, General Auditor policies generally do not require the timely followup of recommendations made by Board review teams in these activity areas. No collective, System-wide approach toward auditing these areas has been formally adopted, although the Conference of General Auditors debated its role in these areas several times. Board support of this expanded role has also been uneven, contributing to the uncertainty which has surrounded these activities. The Board's Staff Director for Federal Reserve Bank Activities recently proposed that the General Auditor be excluded from reviewing areas involving bank examiner judgments. This position is inconsistent with existing professional internal

auditing standards which prescribe an unrestricted scope of review for internal auditors.

General Auditors rarely perform operational reviews of bank supervision and regulation and economic research activities

Operational reviews, which Conference of General Auditors defines as reviews of a function's efficiency and effectiveness, have generally not been performed by General Auditors in the areas of bank supervision and regulation and economic research. Of the 6,968 audits performed from January 1978 through April 1979, only 1 involved the economy and efficiency of bank supervision and regulation activities. Further, in 1979, only 2 of the 12 General Auditors' audit plans indicated that this activity area would be reviewed. In the economic research area, none of them performed operational reviews during the period from January 1978 to April 1979; only 1 planned work in this area during 1979.

The General Auditors have cited a variety of reasons for the low level of attention given to these areas. In the bank supervision and regulation area, they have said that

--they lack the legal authority from the Board of Governors to audit the function,

--their staff is not qualified to perform such audits, and

--the Board of Governors' Division of Bank Supervision and Regulation reviews the function at Reserve Banks.

In the economic research area, General Auditors have said that they believe special training will be needed before thay can adequately address this area. In response, a Board staff characterized these reasons as "non-defensible," in that

--no legal impairments to audit activities in this area could be identified;

--audit departments, when confronted by new areas, such as electronic data processing, have historically found ways to acquire any needed specialized expertise; and

--Board involvement in the subject area is no different than in other areas (such as cash) where Board and Bank internal auditors both perform reviews of the same activities.

Both the Board members and the responsible Board staff officials we interviewed did not believe the General Auditors were legally restricted from fully reviewing these operational areas.

While the Conference of General Auditors has developed System-wide approaches to other specialized areas, such as electronic data processing, it has not developed a System-wide position on the General Auditors' role in reviewing bank supervision and regulation and economic research activities. Both the Conference and the Assistant General Auditors Conference have reviewed this question several times. For example, in the June 1978 Conference of General Auditors' meeting, the General Auditors discussed the proper level of audit attention for these areas. But, instead of adopting a System-wide approach, the General Auditors passed a motion to leave the decision of attention to the individual Reserve Banks. The General Auditors again discussed the issue in the June 1979 meeting and, this time, referred the question to the Assistant General Auditors Conference for consideration. This Conference, meeting in August 1979, passed the following recommendation:

"The Assistant General Auditors recognize the appropriateness of maintaining an audit presence in all areas of Bank activities. To ensure that the supervision and regulation function of each Federal Reserve Bank is appropriately reviewed by internal audit, we suggest that the Conference of General Auditors, through the Steering Committee, appoint an Ad Hoc Task Force for the purpose of studying, developing and recommending guidelines to be used in making such reviews."

Meeting in November 1979, the Conference of General Auditors set up an ad hoc committee to study this area again.

This reluctance to become involved in reviewing these areas, has in part, been encouraged by the Board staff's own uncertain position. While Division of Federal Reserve Bank Operations officials have issued strong unofficial positions that General Auditors should be reviewing these

areas, as of November 1979, no General Auditor reviewed by this same Division had ever been criticized for not performing work in these areas because the Board staff felt the Board's official policy on this matter was unclear.

In September 1979, the Staff Director for Federal Reserve Bank Activities proposed a statement of position, which was adopted by the Conference of Federal Reserve Bank Presidents, addressing internal auditing's role in these areas. While the statement supported auditor involvement in these areas, it also characterized their role as performing something other than "substantive operational reviews":

> "The General Auditor should have access to all areas of the Bank for the purpose of performing financial audits, which includes verifying department management's compliance with Bank and Board policy, controls, and budgeted staff and expenditure levels. We have not advocated that the General Auditor perform substantive operational reviews which involve evaluation of the effectiveness of a function or the competence of professional staff in such areas as research, legal, bank supervision and regulation, and public information. We do feel that it would be appropriate, however, for the General Auditor to call to the attention of Bank management observed idle time of employees due to overstaffing, and like situations that are related to resource utilization. In my judgment, it would not be within this purview to decide or recommend optimal staffing levels or to intrude into how resources are used or other similar questions which are clearly the prerogatve of department management. This is obviously a fine line of distinction. Our staff calls upon the General Auditor to follow up on operational reviews in all areas, and we would expect to continue to do so."

As of February 1980, the Staff Director for Federal Reserve Bank Activities indicated that neither the Board nor the Conference of General Auditors had formally supported his statement of position, although he has received informal support for the statement from both Board officials and

Reserve Bank General Auditors. While noting that the statement needs to be further defined in terms of specific operational situations, the Staff Director indicated that he expected the Conference of General Auditors to support his position.

The Staff Director for Federal Reserve Bank Activities believes his statement should be interpreted as to exclude General Auditors from performing operational reviews of areas involving bank examiners' judgments. The Staff Director believes that this area is a uniquely sensitive function, meriting exclusion from the General Auditors' scope of review. He also acknowledged that his position is not consistent with the unrestricted review scope advocated by professional internal auditing standards.

While we recognize the special sensitivity involved in performing operational reviews of bank examination and supervision activities, we believe that, to be of maximum effectiveness, internal audit units should have unrestricted scopes of reviews. We believe that with appropriately qualified staffs, internal auditors can provide meaningful evaluations of sensitive issue areas, including examiner compliance with established examination policies and procedures. One such audit has already been completed by a General Auditor.

Reserve Bank report recommendation followup policies do not effectively address Board operational reviews of bank supervision and regulation and economic research activities

While FRS management has established an informal System-wide position advocating the followup of Board operational reviews of bank supervision and regulation and economic research activities, individual Reserve Bank policies have not incorporated the System-wide position and do not effectively address this area of followup.

While the Conference of General Auditors has established specific System-wide approaches regarding many internal audit activities, the followup of Board operational reviews is not addressed specifically. Within the Conference's System-wide standards, the need to follow up on the status of audit report recommendations is addressed in the due professional care area. Specifically, this section states:

> "Due professional care also includes follow-up work on findings resulting from similar audits made previously to determine whether appropriate corrective measures have been taken."

No specific reference is made with regard to followup responsibilities for Board operational reviews.

Although no System-wide policy exists, Board practices and statements by Board officials have encouraged the establishment of report recommendation followup systems within each Reserve Bank internal audit unit. Board review teams specifically evaluate this area and have reported deficiencies in their reports to bank management. Board officials have also reiterated to the General Auditors, on several occasions, their unofficial view that General Auditors should follow up on all Board operational reviews.

While General Auditors have been encouraged to follow up on Board operational reviews, our review of the individual report recommendation followup policies at each of the 12 Reserve Banks indicates that many policies do not effectively address followup of Board operational audits in the bank supervision and regulation and economic research areas. Of the 12 policies reviewed, 7 call for the General Auditor to follow up on Board recommendations during their next review of the area; 2 call for followup within a specific time frame; 2 did not have specific timeframes for followup; and 1 indicates that followup will be based on management's response. Of the 7 Reserve Banks whose policies call for followup on Board recommendations during their next review of the area, only 1 Bank has conducted such a review. Therefore, in practice, Board recommendations would not be subject to routine followup at those 6 Reserve Banks where such action is provided for in their policies but not carried out.

CONCLUSION

Reserve Bank internal audit units are staffed with qualified auditors, organizationally independent, and aligned to report to the highest practicable level. In addition, management has established a System-wide set of auditing standards and a quality control review program, which reviews Reserve Bank internal audit operations on a periodic basis. Reserve Bank internal audit units have concentrated their efforts on financial and compliance audits of areas of high financial exposure.

Although Reserve Bank internal audit units have performed many audits, General Auditor attention to the efficiency and effectiveness of bank supervision and regulation and economic

research activities has been extremely limited. In addition, General Auditor report recommendation followup policies generally do not call for the effective followup of Board reviews of supervision and regulation and economic research activities. As a result, these important policy areas are receiving minimal coverage, even though findings have resulted from the limited work performed to date. General Auditors are uncertain as to the coverage management wants them to provide in these areas. The Staff Director for Federal Reserve Bank Activities has proposed that the General Auditor be excluded from reviewing areas involving bank examiners' judgments. This position is inconsistent with existing professional internal auditing standards which advocate an unrestricted scope of review for internal auditors.

AGENCY COMMENTS AND OUR EVALUATION

Although the Board indicated that it generally agreed with our comments relative to Federal Reserve Bank internal auditing activities, the Board did not agree to clearly support an unrestricted scope of review for Bank internal auditors and clarify Bank internal auditor followup activities. The Board's position regarding the scope of review for Bank internal auditors remains unclear. Although the Board stated its belief that all staff functions should be subject to the same potential for audit attention as other Reserve Bank operations, the Board also qualified internal auditors' scope of review in these areas to exclude any evaluation of professional efficiency and effectiveness as well as the end product of professional staff work. This restriction is significant, because professional activities dominate both the supervision and regulation and the economic research areas. (See Appendix II.)

We continue to believe that Federal Reserve Bank internal auditors should have a clear, unrestricted scope of review, extending into the professional activities of these staff functions. Such a scope of review would be consistent with professional internal auditing standards.

RECOMMENDATIONS

We recommend that the Chairman, Board of Governors of the Federal Reserve System:

--Require that Reserve Bank General Auditors review the efficiency and effectiveness of bank supervision and regulation and economic research activities.

--Instruct the Conference of General Auditors to amend their "Audit Standards and Levels of Audit Attention for Federal Reserve Banks" to include a System-wide approach toward reviewing bank supervision and regulation and economic research activities and a specific operational policy statement requiring the followup of Board of Governor's reviews by General Auditors. These changes should be made within a specific timetable which the Board of Governors should monitor.

CHAPTER 4

SCOPE OF REVIEW

Our findings and conclusions are based on work performed at the Board of Governors in Washington, D.C., and at the Federal Reserve Banks of New York, the largest Federal Reserve Bank, and Boston, a representative smaller Bank. Our overall evaluation addressed eight areas of internal audit activity: scope, organizational placement, program planning, staffing, training, report quality, report recommendation and followup, and coordination with external auditors.

In addition to our onsite work at New York and Boston, we obtained and analyzed budgets, audit program plans, report recommendation followup policies, and staffing qualifications from the other 10 Reserve Banks. We also reviewed the work-papers for the last five full scope reviews of individual Reserve Bank General Auditor units performed (as of May 1979) by the Board's Audit Review Section within the Division of Federal Reserve Bank Operations.

The Organizational Structure and Management Control Strategy of the Federal Reserve System

The Federal Reserve System is a large and complex organization which functions as the central bank of the United States. FRS formulates and implements a wide range of financial policies dealing with such areas as monetary activities, Federal Reserve Bank activities, commercial banks' supervision and regulation, and internal management activities of the Board of Governors. To formulate and implement these policies effectively and efficiently, the System's management control strategy consists of a functionally aligned organizational structure supported and coordinated by various information processes, including an extensive budgetary process. Information flows by means of these processes from operating levels to policymaking levels where the information is evaluated and decisions are made. To supplement these other controls, FRS also uses internal audit as a part of its management control strategy.

ORGANIZATIONAL STRUCTURE

The Federal Reserve System includes the Board of Governors, the Federal Reserve Banks and their branches, and the nearly 5,500 commercial banks that are members of the System. The System has been organized on a decentralized basis within two basic tiers:

--The Board of Governors, including their 13 supporting operating divisions and offices.

--The 12 Federal Reserve Banks and their 25 branches, serving and supervising their member banks.

These tiers are supported by a number of System conferences and committees which consider System-wide questions and act as coordination mechanisms. The following organization chart shows the primary duties of the important components of FRS.

THE FEDERAL RESERVE SYSTEM

The basic function of the Federal Reserve System is to make possible a flow of credit and money that will foster orderly economic growth and a stable dollar, encourage business and employment, and facilitate long-run balance in our international payments. The System was created by the Federal Reserve Act which became law on December 23, 1913. The statute provides for a Board of Governors in Washington, the 12 Federal Reserve Banks and their branches, the Federal Open Market Committee, the Federal Advisory Council, and the member banks. The relationships of those groups are indicated below. Solid lines indicate statutory relationships, broken lines, an informal relationship.

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

The Board is comprised of seven members, each appointed by the President and confirmed by the Senate for a term of 14 years. It is an independent agency of the Federal Government, reporting directly to the Congress. The Board's primary responsibilities include the formulation of appropriate credit and monetary policies to carry out the basic function of the Federal Reserve System. It also has certain supervisory responsibilities with respect to the Reserve Banks, bank holding companies, and banks belonging to the System.

Information

FEDERAL OPEN MARKET COMMITTEE

This Committee is comprised of the seven members of the Board of Governors, the President of the Federal Reserve Bank of New York and four other Reserve Bank presidents who serve on a rotating basis. The Committee meets in Washington at frequent intervals to determine System open market policy. To carry out its policies, the Committee directs the purchase or sale of Government securities in the open market for the purpose of influencing the supply and availability of money and credit. The Committee has annually designated the New York Reserve Bank to act as agent in executing transactions for the System open market account.

Advice and recommendation

Consultation and recommendation

FEDERAL ADVISORY COUNCIL

The Council is comprised of one banker from each Federal Reserve District selected annually by the board of directors of the Federal Reserve Bank. It meets four times a year in Washington and confers with the Board of Governors on business conditions, credit and monetary policies, and other System matters.

Directions re open market operations

Consultation and recommendation

Information

CHAIRMEN'S CONFERENCE

An informal organization of the Chairmen of the 12 Federal Reserve Banks, the Conference meets at least once a year generally in Washington. Matters of interest to the System are discussed from the standpoint of the Chairmen in their dual capacity as Chairmen of the boards of directors of the Reserve Banks and as statutory agents of the Board of Governors of the Reserve Banks.

Supervisory and regulatory relations

PRESIDENTS' CONFERENCE

An informal organization of the Presidents of the 12 Federal Reserve Banks, the Conference meets at least quarterly, primarily for the purpose of helping to coordinate System operations. The Conference considers a wide variety of System policies and makes recommendations to the Banks and to the Board. It has many committees, consisting of the Presidents and other officers of Reserve Banks, to study and make reports and recommendations on problems arising in System operations. There is also a Conference of the 12 First Vice Presidents which is organized and operates in a similar manner.

Consultation and recommendation

Consultation and recommendation

THE TWELVE FEDERAL RESERVE BANKS

For the purpose of administering the Federal Reserve System, the United States has been divided into 12 Federal Reserve Districts with one Reserve Bank in each District. The Reserve Banks differ from commercial banks in that profits are not the objective of their operations, and their stockholders, which are the member banks of the Federal Reserve System, do not have the powers and privileges that customarily belong to stockholders of private corporations.

Each Bank is under the immediate supervision and control of a board of nine directors. Under law, three Class A directors, who represent the member banks, and three Class B directors, who are engaged in pursuits other than banking, are elected by the member banks in each District. The three Class C directors are appointed by the Board of Governors, one is designated chairman and another deputy chairman. The chief executive officer of each Bank is its President. He and the First Vice President are each appointed by the board of directors, with approval of the Board of Governors, for a term of five years.

The Reserve Banks are the principal medium through which the monetary and credit policies and general supervisory powers of the System are exercised. They perform for member banks many of the services which member banks perform for the public. In addition, they are fiscal agents, depositaries, and custodians for the United States Treasury and certain other Government agencies.

The Reserve Banks maintain 25 branches and 9 additional offices for check processing in principal cities of the United States. The branches perform for their territories most of the functions performed at the head office. Subject to the regulations of the Board of Governors and general supervision by its parent Reserve Bank, each branch is under the immediate supervision of a board of either five or seven directors, a majority being appointed by the Reserve Bank and the remainder by the Board of Governors.

The locations of the twelve Federal Reserve Banks and their branches and other offices are shown below.

Federal Reserve Bank of												
Boston	New York	Philadelphia	Cleveland	Richmond	Atlanta	Chicago	St. Louis	Minneapolis	Kansas City	Dallas	San Francisco
Offices:	Branch:		Branches:	Branches:	Branches:	Branch:	Branches:	Branch:	Branches:	Branches:	Branches:
Lewiston	Buffalo		Cincinnati	Baltimore	Birmingham	Detroit	Little Rock	Helena	Denver	El Paso	Los Angeles
Windsor Locks	Offices:		Pittsburgh	Charlotte	Jacksonville	Offices:	Louisville		Oklahoma City	Houston	Portland
	Buffalo		Office:	Communications Center	Miami	Des Moines	Memphis		Omaha	San Antonio	Salt Lake City
	Cranbrook		Cincinnati	Culpeper	Nashville	Indianapolis					Seattle
	Jericho			Office:	New Orleans	Milwaukee					
				Columbia							

MEMBER BANKS

All national banks are required by law to be members of the System. Banks with State charters may voluntarily join the System, if qualified for membership, upon approval by the Board of Governors. Somewhat less than half of all banks in the United States belong to the System but these banks hold about 70 per cent of the country's total bank deposits.

Each member bank is required to hold stock in its Federal Reserve Bank in an amount equal to 3 per cent of the member's capital and surplus. Each member bank is also required to maintain its legal reserves with its Federal Reserve Bank and comply with other System regulations.

In return, member banks are entitled (1) to borrow from the Reserve Banks, (2) to use System facilities for check clearance and transfer of funds, (3) to obtain currency, and (4) to share in the informational facilities provided by the System.

Services and supervision

APPENDIX I

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MANAGEMENT CONTROL STRATEGY

Within the Federal Reserve System, management control is achieved through a functional organizational structure, supplemented by formal management reporting systems. FRS management makes extensive use of budgetary systems within their management control system.

Management control begins with delegated authority and planned operations, continues through performance, and includes reporting on performance. A well-designed system of management control helps to insure efficiency, economy, and achievement of planned results. Such a system includes carefully devised and frequently updated standards for designing, conducting, and measuring the output of programs and operations. The essence of management control is the action which adjusts operations to conform with prescribed or desired standards or requirements. To take this action, management needs timely and adequate information on performance.

To increase FRS efficiency and effectiveness, FRS has numerous efforts at all management levels to acquire and analyze data pertaining to its operational functions. Information flows continuously up and down the agency to various management levels where it is evaluated and used within the decisionmaking process to plan, manage and control FRS activities. Each organizational level is responsible for administering delegated authority and reporting on performance to a higher management level. The System's functional organizational structure facilitates its management control approach by requiring major operating functions to be reviewed at each organizational level.

Federal Reserve System Budget

In addition to line management's continuous review and monitoring of performance information, FRS has instituted formalized budget review processes which include periodic reporting and monitoring mechanisms. Both Board of Governors' operating divisions and offices and individual Reserve districts are controlled by operating budgets, formulated, approved, implemented, and monitored under directives of the Board of Governors.

Board of Governors Division and Office budgets are formulated, implemented, and monitored at the Board level. To initiate the process, in mid-summer, Board divisions and offices submit tentative budget estimates to the Controller. The Controller merges these proposals with other known and anticipated factors into a projected budget level and submits it to the Chairman and Vice Chairman of the Board. Based on their review of the consolidated proposal, the two Governors establish budget guidelines, such as the percentage limitation by which the new budget shall exceed the present estimated expenses. The Divisions are governed by these guidelines when formulating their budget proposals; for example, the Board approved a 1979 budget guidelines allowing an increase of 7.35 percent above current year expenses.

After budget proposals are initially formulated by the Divisions, they are reviewed by the Controller and the cognizant Board committees. Initially, Division and Office directors meet with the Controller and the Staff Director for Management to negotiate their budget proposals. Similar meetings are held with the responsible Board committee. Following these reviews, the Controller and the Board committees combine the resulting individual proposals into a consolidated budget and present it to the Vice Chairman, who determines whether to accept the proposal or to institute changes. Following his review the Vice Chairman presents the budget to the entire Board for final approval.

Following Board approval, budget implementation occurs under delegated authority from the Chairman of the Board to the Vice Chairman. While the Vice Chairman must approve changes to the headquarters budget up to 1-1/2 percent beyond the Board-approved operating plan, most budget implementation responsibilities extend to Board Division and Office management.

The Controller is responsible for monitoring the cumulative totals of administrative actions so the Chairman and Vice Chairman are kept informed as to when expenditures are approaching budget limitations. Board Division financial reports are generated automatically each month. The Controller reviews these reports and informally reports to the Board quarterly. Also, the Controller, on a formal basis, presents mid- and end-of-year reports to the Board on the performance of division offices. These reports are very extensive and include information on the financial performance of each Division, positions and employment information,

program changes, data processing, resources utilization performance, and the effects of new bank legislation on Board manpower. These reports are based on information which is provided to the Controller by Board Divisions and Offices.

Similar to the Board budget process, the individual budgets of the 12 Federal Reserve Banks are also approved and monitored on a System-wide basis by the Board of Governors. Initially, each Reserve Bank submits tentative objectives and goals to its Board of Directors, who, after a review, submits them to the Board of Governors. These proposals are reviewed and evaluated by a review team consisting of the Board's Committee on Federal Reserve Bank Activities, the Staff Director for Federal Reserve Bank Activities, the Division of Federal Reserve Bank Operations personnel, and representatives from the Conferences of Federal Reserve Bank Presidents and Vice Presidents. This review team considers are projected System goals, economic conditions, current level of System operations, and historical performance. The review team formalizes System-wide budget objectives and presents them to the Board of Governors for approval. Upon approval, these System-wide objecobjectives are distributed to each Reserve Bank President as guidelines to use in formulating initial budget submissions. In September, each Reserve Bank submits preliminary district budgets to the Division for Federal Reserve Bank Operations, where they are analyzed on an individual basis. Upon completion of this analysis, the review team and the individual Reserve Bank presidents and Vice Presidents meet and negotiate the submissions. Following this review, the Reserve Banks revise their initial submissions, if necessary, and resubmit their final budgets to the same headquarters review group. If no additional changes are required, the Board Committee on Federal Reserve Bank Activities submits the consolidated requests to the full Board for final approval.

Reserve Bank budget implementation responsibilities are split among Reserve Bank management, Board Divisions, and the Staff Director for Federal Reserve Bank Activities, depending upon the size and nature of the activity being implemented. Board divisions have approval authority over some Reserve Bank activities, such as major employee compensation decisions or large contracts. In addition, the Staff

Director for Federal Reserve Bank Activities, who is responsible for System-wide management of resources, may also need to approve an item, depending on the nature and cost of the expenditure.

A System-wide reporting network exists to determine how effectively Reserve Banks are managing within their budget. Quarterly monitoring of performance relative to goals is done through the planning and control system (PACS). Under the PACS' reporting system, each Reserve Bank quarterly submits to the Board the actual expense charged against the budget by service line items. Based on this information, which also includes the number of employees and the volume of production, the Board generates PACS reports, wherein the Board can determine the cost versus the performance of each Reserve Bank. Two types of cost measures are provided--a time series measure and a cross sectional or inter-district measure. The time series measure compares the expense of producing this year's volume of products with the expense of producing the same volume at last year's cost level. The cross sectional measure compares a district's expense with the expense of producing the district's volume at System average cost levels. The units of measurement are the number of items processed. This system accounts for approximately 80 percent of the Reserve Bank expenses since certain activities, such as research and bank supervision and regulation are not readily quantifiable. Based on PACS information, the Division of Federal Reserve Bank Operations presents mid- and end-of year reports to the Board on Bank budget performance. PACS information is also included in the Staff Director for Federal Reserve Bank Activities' annual reports to the Committee on Federal Reserve Bank Activities on the individual Reserve Banks' performance. These reports are to be used as components in the annual evaluation of the Reserve Banks, made by the Committee on Federal Reserve Bank Activities, which includes recommendations on salary increases for Reserve Bank officials.

In addition to the Board of Governors' monitoring activities, an internal expense budget network has been established within each Federal Reserve Bank to track expenses against the Reserve Banks' budget down to departmental levels. Reports are submitted to the Reserve Banks' Board of Directors and need not be shared with the Board of Governors.

Delegated authority reporting

Another form of Federal Reserve Bank reporting to the Board deals with delegated authority. The Reserve Banks must report weekly to the Board on any action taken under delegated authority. Each report to the Secretary of the Board must include information on actions taken regarding (1) supervisory matters, including financial institution applications accepted by the Reserve Bank during the week and (2) Reserve Bank operational matters under delegated authority such as certain contracting decisions. These weekly reports must list: delegated item number, date action taken and rationale of action taken, dollar consideration, etc. Each Reserve Bank is also required to provide the Staff Director for Federal Reserve Bank Activities and the Director of Division of Personnel with quarterly reports on decisions made under delegated authority pertaining to Reserve Bank examinations, budgets, and operations and personnel matters, respectively.

Internal auditing role in FRS management control systems

Within FRS, internal auditing activities and resources have been concentrated at the Reserve Bank level. While no permanent, independent internal audit group has been established at the Board of Governors, each of the 12 Reserve Banks has an internal audit group. These Reserve Bank internal audit groups have been used primarily to supply Bank management with independent evaluations of Reserve Bank operations, particularly in the area of financial controls. (See report chapter 3.) In addition to these Reserve Bank internal audit groups, several Board operating Divisions also perform periodic operational and financial reviews of selected Reserve Bank activities. The results of these reviews are reported to Reserve Bank management and the appropriate Board standing committee.

APPENDIX II

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON, D.C. 20551

May 7, 1980

Mr. Allen R. Voss
Director, General Government Division
U. S. General Accounting Office
Washington, D. C. 20548

Dear Mr. Voss:

Thank you for the opportunity to review and respond to the draft report of the General Accounting Office ("GAO") on the Federal Reserve System's Use of Internal Auditing. Since the report makes separate recommendations with respect to the Board and the Federal Reserve Banks, the recommendations are treated separately, below.

GAO's Recommendation with Respect to the Use of Internal Auditing

It is the Board's belief that the present combination of its Operations Review Program ("ORP"), Office of the Controller, and external auditor have served and can continue to serve the needs of the Board well in the areas of operations review and financial controls. However, it is also the Board's belief that some immediate refinements in the areas of independence conflicts and follow-up can be made to improve the effectiveness of the ORP's operations.

The GAO is correct in observing that the Office of the Controller is limited to the financial and operational control area and, in the case of its line operations, reports to the Board through the Staff Director for Management. However, the Controller has enjoyed and will continue to enjoy a direct reporting relationship to the Board on matters falling within his jurisdiction that he feels must be brought to the attention of the Board directly. These areas include, but are not limited to, investigations of fraud and waste, inappropriate use or inadequate protection of the Board's assets, and improper functioning of the Board's financial controls. While the staff of the Office of the Controller specifically assigned to these functions report to him on all matters, this reporting chain is necessary and not unusual as the responsibility for these functions is vested in the Controller who employs staff to assist him in these matters. Even in the presence of an internal auditing group such as is recommended by GAO, the Office of the Controller would continue to perform the above functions and enjoy a direct reporting relationship to the Board.

GAO is also correct in observing that the external auditor's activities are limited to the area of financial controls. Again, even in the presence of an internal auditing group such as GAO recommends, the Board would continue to employ an external auditor for those functions currently performed.

Since the ORP would most immediately be affected if the Board were to adopt GAO's recommendation, the remainder of these comments address the issues raised by GAO in its report on that program.

The ORP was established by the Board in mid-1978 with the help of the Board's external auditors in order to bridge the one gap that existed in the Board's internal auditing functions, i.e., compliance, efficiency and effectiveness reviews of the Board's operations. Various alternative structures were considered at that time but the ORP structure was adopted for several reasons:

- to insure the availability of staff who knew the nature of the Board's operations;

- to provide an educational vehicle for divisions through participation on the Operational Review Committee ("ORC") and the review teams;

- to use an already available pool of System resources trained in operational reviews; and

- to maximize the probability of identifying areas for improvement and implementing solutions once derived.

It was also felt that the size of the Board's staff would not warrant the staff that would have to be retained in order to have the experts trained in the areas of the Board's business and operations reviews. It is the Board's belief that these reasons are still applicable today.

Three additional aspects of the ORP's background are worth noting to put the issues that GAO raises in perspective.

First, during its first year of operations the ORP, as expected, experienced start-up difficulties. In December 1979, recommendations were made to the Vice Chairman to remedy those difficulties that were identified. The ORC will continue to monitor its operations carefully and make recommendations to the Vice Chairman to take account of deficiencies in its charter and mode of operations.

Second, no follow-up responsibility was given to the ORP on its report recommendations since it would frustrate the ability to attract qualified staff for the ad hoc reviews. It is now recognized that follow-up actions, when left to line management, might produce inconsistent results and that reviews can be more effective with planned follow-up reviews.

Finally, anticipating that there would be independence conflict questions, the ORP's charter incorporated precautions to guard against such conflicts. These precautions have been and will continue to be applied aggressively. Each team member is examined carefully for potential conflicts and actions are taken by the ORC to preclude conflicts. In the event that a conflict cannot be resolved, team members would be disqualified. In the event that it would be desirable to retain an individual for a review, the review of the program causing the disqualification would be postponed until some later time. It is not the ORP's mandate to review all of a division's operations at one time.

The single instance cited in the GAO report to demonstrate that the Board's ORP operations are hampered by the use of part-time personnel involved the unilateral action by the team leader of a review in deleting from the scope of the review a function that he helped establish and that had been recently transferred to the reviewed division at the time of the review. Presumably, had the ORC known that a conflict existed, it would have taken appropriate measures to resolve the conflict. Because of the team leader's expertise in the operations of the division under review, if no other measures could be found to avoid the conflict, the ORC itself had the option to delete the program from the scope of the review in favor of a later review and retention of the team leader. The ORP is not charged with reviewing whole divisions at any one time. Any programs so deleted from a review will be reviewed at a later date.

The Board is satisfied that the current combination of the Office of the Controller, the external auditor, and the Operational Review Program are satisfying its needs and requirements in the areas of operations reviews and financial controls. In addition, the reasons that were present at the time that the ORP structure was adopted still exist today. The Board has no substantive evidence to permit the conclusion that the ORP is not producing substantive results. The GAO report acknowledges that the two reviews conducted prior to the time of the GAO study surfaced many good recommendations. However, in view of the first year's experience with the ORP's operations and the insights offered by the GAO report, the Board has asked the Vice Chairman to effect improvements in the ORP's charter in the areas of indepedence conflicts and follow-up responsibilities including hiring a full-time director of ORP review activities. It is expected that these improvements will be made by July 1, 1980.

GAO's Recommendations with Respect to the Federal Reserve Banks

The Board of Governors has considered and is in general agreement with the report comments relating to the appropriateness of audit involvement and follow-up activities in Reserve Bank research and bank supervision and regulation functions.

The Board has concluded that these and all staff functions should be subject to the same potential for audit attention as are other Reserve Bank operations. The scope of this audit attention should include review of the management of resources in compliance with established policies and procedures. However, the scope of such attention should exclude any evaluation of professional efficiency and effectiveness as well as the end product of professional staff work. This focus should result in audit evaluations of the level of compliance with prescribed policy and procedures and evaluations of administrative efficiency and effectiveness of staff functions.

This conclusion acknowledges that, traditionally, System audit resources have been dedicated largely to those operating areas characterized by vulnerability to financial loss or related embarrassment to the Banks. The Board believes that regular independent audit attention to staff functions that involve different kinds of risks would be similarly useful to System management.

This conclusion is being communicated to all Federal Reserve Banks. In addition, the Board's position was discussed with the Conference of General Auditors which then passed a resolution charging a task force with responsibility for developing a core program for use by all General Auditors in conducting reviews of research and bank supervision and regulation functions.

In the Board's opinion, its endorsement of the appropriateness of regular audit involvement in Reserve Bank staff functions obviates specific action on audit's follow-up on Board reviews of research and supervision and regulation. The endorsement is expected to clarify the question of audit presence in these areas so that the accomplishment of audit follow-up in staff functions will be similar to that which has been consistently performed for Board attention in other areas.

As a point of clarification, the Board wishes to advise the General Accounting Office of an apparent misunderstanding of the opinion of the Staff Director for Federal Reserve Bank Activities on audit involvement in testing for examiner compliance. The Staff Director does not believe that auditors should be excluded from assessing examiners' performance in complying with prescribed policies and procedures. This apparent misunderstanding is represented in the report on pages IV, 18, 21, 30, and 32. (See GAO note on p. 48.)

We appreciate the opportunity to comment on the GAO report and for the professional manner in which your entire staff conducted itself during the study.

Sincerely yours,

Theodore E. Allison
Secretary of the Board

GAO note: As shown on pages IV, 19, 22, 31, and 33, the statement of the Staff Director for Federal Reserve Bank Activities was revised to recognize that he proposed that General Auditors be excluded from areas involving bank examiner judgments.